85-317

Supreme Court, U.S.
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No. _____

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1985

DUANE O. and JEAN HESTNES,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF PETITIONERS

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QUESTIONS PRESENTED

1. Was the taxpayer denied due process of law when evidence was insufficient to support the tax court's finding of fraud?

2. Are unclaimed business deductions relevant on the question of fraudulent intent?

3. Was the Commissioner's determination of constructive dividends arbitrary and erroneous in light of unrefuted evidence showing a lawful cash source?

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OPINIONS BELOW

The tax court memorandum findings of fact and opinion is unreported (Pet. App. A1-A48). The order of the court of appeals affirming the tax court is also unreported (Pet. App. A49-A83).

JURISDICTION

The order of the court of appeals was entered on April 11, 1985 (Pet. App. A49-A83). A timely petition for rehearing, with suggestion for rehearing in banc, was filed on April 25, 1985. The court of appeals denied the petition for rehearing by order dated May 15, 1985 (Pet. App. A84-A85). The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

STATUTES INVOLVED

26 U.S.C. §6501 provides in relevant part:

Limitations on assessment and collection

(a) General rule. Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed). . . and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

. . . .

(c) Exceptions.

(1) False return. In the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.

26 U.S.C. §7454(a) provides:

Burden of proof in fraud, foundation manager, and transferee cases.

(a) Fraud. In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary.

Tax Ct. R. 142(b) provides:

Burden of proof.

. . . .

(b) Fraud. In any case involving the issue of fraud with intent to evade tax, the burden of proof in respect of that issue is on the respondent, and that burden of proof is to be carried by clear and convincing evidence. Code section 7454(a).

STATEMENT OF FACTS

Petitioner Duane Hestnes has been in the business of slaughtering cattle and processing meat since 1955; his company has been in Stoughton, Wisconsin, since 1965. When he first began working in Stoughton, Hestnes slaughtered cattle and also sold meat in a small retail outlet in his plant. In 1968, Hestnes became a small wholesaler who supplied beef to meat distributers, dropping entirely the retail sale of meat in late 1968 or early 1969. Hestnes still works on the kill floor of the plant.

Hestnes' small meat slaughtering business developed a unique reputation. In order to compete with large slaughterhouses, Hestnes paid cash for distressed cattle which others generally would not buy. Purchasing cattle for cash is a common practice in small slaughtering operations because payment in cash lowered the purchase prices. Meat from the distressed cattle ultimately was subject to health inspection.

Most of Hestnes' business transactions were by check. Many of distressed cattle purchases were from regular dealers, who were paid weekly by check. Hestnes sometimes bought unafflicted cattle at sale barns and paid by check. Hestnes received payment for slaughtered cattle by check. He also sold the by-products of the slaughtering

process and received payment by check.

Hestnes regularly kept a great deal of cash on hand. He liked to keep his personal funds in cash. He also needed cash to make quick cattle purchases. Hestnes always used his bank in Stoughton and regularly deposited checks. He would cash checks from his regular suppliers, but primarily he cashed checks he received from the sale of by-products.

Hestnes kept minimal records. He felt he was not qualified to keep books and he was busy on the kill floor. Hestnes kept a list of cattle slaughtered on a calendar which he called the "kill book." His employees kept another calendar called the "weight book" where they would enter the weight of slaughtered cattle. From the weight book, a makeshift accounts payable ledger, Hestnes

could determine the amount he owed each of his suppliers. Hestnes kept his invoices for sales of meat in a pile in a desk drawer.

Hestnes' business, known as S & S Meats, started as a sole proprietorship. He incorporated it on September 1, 1972, electing not to transfer to the corporation ownership of the slaughterhouse building. The corporation thereafter paid Hestnes rent in addition to a salary as its president. The proprietorship owned over $43,000 in accounts receivable which were not transferred to the corporation (see Pet. App. A10).

The tax investigation of Hestnes began because, in late 1973, the Internal Revenue Service [hereinafter "IRS"] learned that Hestnes was keeping $21,000 in cash on hand. IRS agents asked to see

Hestnes' books and records, and Hestnes cooperated. Hestnes instructed his accountant to meet with the agents. Early in the investigation, Hestnes told the agents that not all checks he received had been deposited. He also specifically told the agents that he purchased cattle for cash. Hestnes, alone or with his attorney, met with agents over the course of several years.

The tax court assessed deficiencies against Petitioners Duane and Jean Hestnes for the four tax years ending in 1970, 1971, 1972 and 1973, finding that the first three years were not outside the statute of limitations due to fraud. 26 U.S.C. §6501(c)(1). The tax court assessed additions to tax against Duane Hestnes for those three years for fraud. 26 U.S.C. §6553(b).

REASONS FOR GRANTING THE WRIT

I.

TAXPAYER WAS DENIED DUE PROCESS BECAUSE THE TAX COURT'S FINDING OF FRAUD WAS NOT SUPPORTED BY THE EVIDENCE.

The court of appeals concluded that the tax court's finding of fraud should be sustained. According to the appellate court, the tax court's finding of fraud rested upon the following conduct by Hestnes: (1) false statements to Reppert that all gross receipts were deposited when in fact numerous checks had been cashed; (2) a pattern of cashing checks from the sale of by-products on days other than when Hestnes made regular deposits, and of not cashing checks from regular customers; (3) a pattern of consistent failure to disclose or report income; and (4) Hestnes' failure to maintain adequate books and records (Pet.

App. A62).

The factual record did not support the inferences of fraud from any of the factors relied upon by the tax court, especially in light of Candela v. United States, 635 F.2d 1272 (7th Cir. 1980).

The taxpayers in Candela, Filippo and Providenza Candela, sought a refund for assessed tax deficiencies amounting to over $60,000. The Candelas emigrated from Italy in 1925. In 1941, Candela started working at the Grande Cheese Company in Wisconsin. The Candelas lived frugally, Providenza took in lodgers, Filippo worked seven days a week. In 1967, Filippo paid $60,000 to purchase the Grande Cheese Company. In forty years of residing in the United States, Filippo never learned to read or write and never learned to speak much English.

Through 1967, Filippo's barber prepared his tax returns. The job was then turned over to his accountant. The Commissioner assessed deficiencies against the Candelas for tax years 1967, 1968 and 1969.

The district court in Candela found fraud based on three "indicators": (i) Filippo Candela had a "high degree of business acumen" and must have understood his obligation to report certain sales as income; (ii) he failed to keep records and failed to report profits and losses from certain cheese sales; and (iii) he kept money in an out-of-state bank. 635 F.2d at 1274-76.

This appellate court in Candela rejected the district court's reasoning as clearly erroneous. The court found that Candela's business acumen extended

only to the production of cheese, noting that Candela kept his money in cash stored in milk cans and safe deposit boxes, instead of in investments. The court held that Candela's naivete did not absolve him, but it did "suggest that the failure to report certain portions of his income was due to negligence or ignorance of the law rather than fraud." Id. at 1275.

The court also found that Candela's practice of undocumented cheese sales was not probative of an intent to evade or defeat tax obligations. Id. at 1275. The court found that no scheme to evade taxes was suggested by this because the cheese transactions would be documented on the books of the cheese purchasers, who paid by check and not cash. Id.

Finally, the court found itself "at

a loss" to see how keeping funds in an out-of-state bank would indicate fraud. Id. at 1276. According to the court, Candela's failure to contact these banks and secure federal forms showing interest income evinced negligence. Id.

In the instant case, the appellate court suggested that Candela was confined to the "unique circumstance of a taxpayer who was an unsophisticated and illiterate immigrant" (Pet. App. A70). The court concluded that Hestnes alleged "no similar degree of naivete or lack of sophistication" (Pet. App. A70-A71). The court incorrectly construed the import of the Candela analysis.

The Candela case cannot be read to turn solely on the characterization of Candela as an "unsophisticated and illiterate immigrant." The court's

rejection of the district court's analysis is grounded on much more broadly based reasoning. The lack of sophistication is mentioned merely as another factor to be considered. The dissent in Candela gives a glimmer of the true state of affairs. Pointing to Candela's growth in wealth, the dissent observes that, despite his lack of facility in English, "Mr. Candela was obviously no babe in the economic woods." 635 F.2d at 1277.

The Candela case shows that at least two of the indicia relied upon the tax court in Hestnes' case are insufficient to support inferences of fraud.

First, the inference of fraud from Hestnes' handling of the by-products checks was improper. The very fact that Hestnes received checks for these by-products sales, rather than cash,

negates any possible fraudulent inference. The checks were documented in the records of the buyers, as were the cheese sales in Candela. As in Candela, "such documentation would not suggest a scheme to evade taxes." 635 F.2d at 1275. Nor does Hestnes' practice of cashing checks on days when he did not make deposits of receipts support an inference of fraud. He used his own bank for these transactions, where he would be recognized and where his presence was noted. Such behavior does not suggest a scheme to hide or conceal his practices.

Second, the reasoning of Candela also requires rejection of the tax court's reliance on Hestnes' unique record keeping habits as evidence of fraud. As Candela shows, the failure to keep records is sometimes evidence of

negligence rather than fraud. 635 F.2d at 1275. The record here supports only the inference that Hestnes' record keeping was not fraudulent. His records were sufficient for him to run his business. Hestnes knew the amounts of money he owed because the names of the sellers plus the number of cattle and their weight had been inscribed in two calendars, the weight book and the kill book. The fact that Hestnes was not a sophisticated businessman bolsters the conclusion that Hestnes' records were not deliberately confused and purposely made incomplete in order to evade tax.

The remaining factors relied upon by the tax court in Hestnes' case also cannot support a finding of fraud. Hestnes' statements during the investigation do not show fraud because he

corrected himself and admitted that all receipts were not deposited. The lack of candor with IRS agents, subsequently corrected, has been rejected as a basis for inferring fraud. See John C. Barrier, 46 T.C.M. (CCH) 100, 109 (1983), quoting Semple v. Commissioner, 10 T.C.M. (CCH) 795 (1951); Charles W. Welch, 36 T.C.M. (CCH) 1020, 1025 (1977).

Finally, a mere understatement of income cannot, without more, support a finding of fraud. Candela, 635 F.2d at 1274; Lofton and Woodward, Inc. v. United States, 577 F.2d 1206, 1239 (5th Cir. 1978); Lydon v. Commissioner, 351 F.2d 539, 545-46 (7th Cir. 1965). If the check cashing, record keeping and initial lack of candor do not show fraud in Hestnes' case, then the mere understatement of income would not alone be suffi-

cient.

The evidence in this case obviously was insufficient to support a finding of fraud. Sustaining the tax court's finding of deficiency upon insufficient evidence constitutes a denial of due process. See Phillips v. Commissioner of Internal Revenue, 283 U.S. 589, 596-97 (1931).

II.

UNCLAIMED BUSINESS DEDUCTIONS SHOULD HAVE BEEN CONSIDERED ON THE ISSUE OF FRAUD.

The single most controverted issue in the tax court was resolved in Hestnes' favor. Hestnes contended, through his own testimony and the testimony of an S & S employee and an expert, that he made cash purchases of cattle throughout 1970, 1971 and 1972. The Commissioner scoffed at Hestnes' claim, calling it an incredible story, unworthy of belief. The tax

court found that Hestnes had made cash purchases of cattle, had not claimed business deductions for those purchases, and was entitled to do so (Pet. App. A30). The tax court properly considered these offsetting business deductions in its final assessment of deficiency (Pet. App. A31). But the tax court erred in failing to consider that these unclaimed deductions showed a lack of wilfulness or fraudulent intent.

The court of appeals incorrectly suggested that it "is not clear. . .from the tax court's memorandum opinion that it did not in fact weigh this finding in its fraud determination" (Pet. App. A72). The court further suggested that, even if the tax court did neglect this factor, the finding of fraud should be sustained (Pet. App. A72).

Even the most cursory reading of the tax court's memorandum opinion reveals that the tax court never considered the unclaimed business deductions on the issue of intent. It is obvious from the memorandum opinion; it is less than candid to suggest that the memorandum opinion is "not clear" and that the tax court might have considered these factors.

The tax court should have considered the unclaimed deductions as demonstrating lack of fraudulent intent. In Plunkett v. Commissioner, 465 F.2d 299, 304 (7th Cir. 1972), the Seventh Circuit held that the fact of unclaimed business "is not without significance" for the issue of supposed fraudulent intent. The position stated in Plunkett is further supported by other authority. United States v. Lenamond, 553 F. Supp. 852, 862 n.27

(N.D. Tex. 1982); Jenkins v. United States, 313 F.2d 624, 627 (5th Cir. 1963); United States v. Cramer, 447 F.2d 210, 218 (2nd Cir. 1971), cert. denied, 404 U.S. 1024, (1972); United States v. Vardine, 305 F.2d 60, 63 (2nd Cir. 1962); Carlos Blanca Perez, 33 T.C.M. (CCH) 946, 952 (1974).[2]

The tax court in Hestnes' case was completely unaware of the significance and import of its own finding on the unclaimed business deduction issue. Its failure cannot be excused by the fiction that, although the memorandum does not so

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[2]The intent to defraud that must be shown is the intent "to evade a tax. . . believed to be owing to the Government." Lofton and Woodward, Inc. v. United States, 577 F.2d 1206, 1236 (5th Cir. 1978). If a person understates his income and also understates his offsetting deductions, he has no belief that tax is owing to the government and so no intent to defraud.

reflect, the tax court might have given consideration to this important factor.

Overlooking the tax court's failure to consider the impact of unclaimed business deductions cannot be justified by suggesting, as the appellate court here has done, that such a failure would not render the tax court's finding of fraud clearly erroneous (Pet. App. A72). The court of appeals gives too much deference to the "clearly erroneous" standard. If it is shown that the tax court wholly failed to recognize the signifigance of the most crucial fact in a case, as is the case here, it can hardly be maintained that the court's judgment should be upheld. The case must be remanded to the tax court for reconsideration taking the new factor into account.

III.

UNREFUTED EVIDENCE FROM THE COMMISSIONER'S OWN WITNESS SHOWING A LAWFUL CASH SOURCE SHOULD HAVE BEEN SUFFICIENT TO SHOW THAT THE COMMISSIONER'S DETERMINATION OF CONSTRUCTIVE DIVIDENDS WAS ARBITRARY OR ERRONEOUS.

The tax court found that Hestnes received corporate cash during 1972 and 1973 which should have been included as income to him in the form of constructive dividends. Hestnes showed that he lawfully possessed large amounts of cash which was his personal property, not the property of the corporation. In particular, he showed, and the tax court found, that he personally owned $43,000 in receivables from the proprietorship which were not transferred to the corporation.

The tax court failed to recognize the significance of the $43,000 in receivables. The court of appeals erron-

eously upheld the tax court, finding that a mere plausible alternate source of cash was not sufficient to show the Commissioner's assessment was arbitrary (Pet. App. A81). The court concluded that Hestnes had not shifted the burden back to the Commissioner to prove the proper amount of tax due.

The taxpayer bears an initial burden of proof in tax cases, Tax Ct. R. 142(a), but is entitled to shift the burden to the Commissioner -- and put the Commissioner to its proof -- by showing that the assessment is "arbitrary or erroneous" Hintz v. Commissioner, 712 F.2d 281, 286 (7th Cir. 1983). If that provision for shifting the burden is to have any meaning, surely it must be applicable here.

Hestnes showed more than a "plaus-

ible alternate source of cash." Hestnes showed that the Commissioner's assessment failed to take into consideration the outstanding receivables. He proved the existence of the receivables and his entitlement to them.

The burden shifting provision exists so that a taxpayer cannot be required to prove that he owes no tax or to prove the amount of tax he owes when he shows the Commissioner is wrong. Helvering v. Taylor, 293 U.S. 507, 515 (1935); Barnes v. Commissioner, 408 F.2d 65, 69 (7th Cir.), cert. denied, 396 U.S. 836 (1969); Herbert v. Commissioner, 377 F.2d 65, 69 (9th Cir. 1967). When the taxpayer has shown that an item is missing from the Commissioner's assessment, it must be concluded that the burden has shifted.

CONCLUSION

Petitioners respectfully ask this Court to grant review.

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APPENDIX

A1

T. C. Memo. 1983-727

UNITED STATES TAX COURT

DUANE O. HESTNES and JEAN HESTNES,
Petitioners v. COMMISSIONER OF
INTERNAL REVENUE, Respondent

Docket Nos. 7933-77, 8215-78.
Filed December 7, 1983.

Robert D. Heidel and Frederic J. Brounder,
for the petitioners.

Joseph R. Peters, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, Judge: In statutory notices of deficiency dated April 14, 1977, in docket No. 7933-77 and April 13, 1978, in docket No. 8215-78, respondent determined deficiencies in petitioners' Federal income taxes and additions to tax under section 6653(b)[1] as follows:

Docket No.	Year	Deficiency	Additions to Tax §6653(b)
8215-78	1970	$ 5,670.19	$ 3,432.83
	1971	17,750.31	10,910.38
	1972	26,639.39	13,319.70
7933-77	1973	19,436.34	---

By order of this Court these cases were consolidated for purposes of trial,

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[1]Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue. Unless otherwise indicated, any reference to "Rules" shall be deemed to refer to the Tax Court Rules of Practice and Procedure.

briefing, and opinion. After concessions, the issues for determination are:

(1) Whether the statute of limitations bars the assessment and collection of the deficiencies, if any, in income tax due from petitioners for each of the taxable years 1970 through 1972;

(2) Whether petitioner Duane O. Hestnes understated the net income from his meat processing business and thereby understated petitioners' taxable income for each of the years 1970 through 1972;

(3) Whether any part of the underpayment of tax, if any, for each of the taxable years 1970 through 1972 was due to fraud on the part of petitioner Duane O. Hestnes within the meaning of sections 6501(c) and 6653(b);

(4) Whether certain expenditures to sponsor a race car are deductible under

section 162 for the taxable year 1972;

(5) Whether certain expenditures to remodel a slaughterhouse are deductible for the taxable year 1972; and

(6) Whether petitioner Duane O. Hestnes received constructive dividends from S & S Meats, Inc., in 1972 and 1973.

Respondent has conceded that Jean Hestnes is not liable for the additions to tax under section 6653(b).

Because the issues herein are largely factual in nature, we have combined the Findings of Fact and Opinion. Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated hereby by this reference.

Background of the Business

Duane O. Hestnes (petitioner) and Jean Hestnes, husband and wife, resided

in Stoughton, Wisconsin, at the time their petitions herein were filed. Petitioners timely filed joint Federal income tax returns for 1970 through 1973 with the Internal Revenue Service Center, Kansas City, Missouri.

In 1965 petitioner opened a slaughterhouse under the name S & S Meats (hereinafter S & S) and operated it as a sole proprietorship. Mrs. Hestnes did not participate in this business. Originally, S & S purchased and slaughtered cattle and sold the meat at retail. Some revenue was also derived from custom slaughtering cattle owned by farmers and returning the meat to the farmers. S & S elected an accrual basis of accounting.

By 1969, S & S had evolved into an operation specializing in the slaughtering of "distressed" cattle and selling

the boned meat at wholesale. Distressed animals are animals that are not healthy. They may, for example, suffer from broken legs, calving paralysis, or foot rot. The retail operations of the business, including the retail portion of the custom slaughtering of animals owned by farmers, was leased by petitioner to Dick Dobrzynski.

All of the animals processed by S & S were inspected by an employee of the Wisconsin Department of Agriculture. During the years at issue herein, S & S purchased animals from three basic sources. The primary source was independent suppliers. These suppliers would visit the farmers in the vicinity of the slaughterhouse, purchase distressed animals, and sell those animals to S & S. These purchases were termed "subject."

If a "subject" animal did not pass inspection, S & S did not have to pay the supplier for it. If the animal passed inspection, the supplier was issued a check based on a negotiated price per pound for the hanging weight of the carcass.

The second source of animals was cattle purchased by petitioner at sales barns. These animals generally were not distressed and were more expensive than those purchased from independent suppliers. Purchases at the sales barns were final (i.e., the risk of the animal's passing inspection was on the purchaser), and petitioner issued checks for these purchases.

The final and smallest source of animals was purchases directly from farmers. Farmers would sometimes bring a

distressed animal directly to the slaughterhouse rather than sell it to an independent supplier on the theory that they could negotiate a better deal with petitioner. The number of such purchases varied; 10-15 distressed animals might be purchased in 1 week, and other times none would be purchased for 2-3 weeks. Some of these purchases were by check and some were for cash. The negotiated price depended, in part, on who bore the risk of the animal's passing inspection and on the form of payment. Some farmers would accept a lower price if payment was by cash. The cash cost of a cow varied. An animal that would cost $200 if the seller bore the risk of passing inspection and payment was by check could be purchased for $50 to $100 in cash.

Although S & S derived the majority

of its revenue from the sale of boned meat, revenue was also derived from the sale of animal by-products. After a slaughtered animal passed inspection, it was eviscerated, the skin was removed, and the carcass was boned. The offal (i.e., the viscera and trimmings from the deboning process) and the animals condemned upon inspection were useful by-products to fat renderers and pet food processors. These by-products were stored in large drums and sold to the purchasers offering the highest price per pound. The total purchase price was not determined, however, until the purchasers weighed the by-products at their own facilities. A final, much smaller source of revenue was fees derived from custom slaughtering animals owned by farmers.

On September 1, 1972, petitioner

incorporated S & S (hereinafter the corporation is referred to as S & S, Inc.) and became its president and sole shareholder. Petitioner retained ownership of the slaughterhouse facilities and leased them to S & S, Inc. Petitioner also retained the accounts receivable, which totaled $43,348 immediately prior to incorporation. After incorporation, the slaughtering operation continued much as it had before except that, for an unknown period of time, petitioner discontinued the practice of occasionally purchasing animals for cash.

Recordkeeping

Petitioner's recordkeeping for S & S was at best minimal. No records were maintained of the number of animals purchased with cash or the amount paid for those animals.

Animals brought to S & S for slaughter were accounted for in a "kill book." Daily entries in that book included the number and type of animal brought in on that date, an indication of whether the purchase was subject to inspection, and the name of the supplier. Sometimes, however, an entry was merely labeled "custom" without identification of the supplier. Although the generally accepted definition within the animal slaughtering industry of the term "custom" refers to the service of slaughtering animals owned by farmers, petitioner also used this term to refer to animals purchased directly from farmers. Entries labeled "custom" in the kill book could refer to either of these two meanings.

After the carcass of an animal passed inspection, it was weighed, and

that weight and the name of the supplier were entered into a "weight book" on the date corresponding to the date that the animal was slaughtered. An exception to this procedure was that the weight of an animal listed as "custom" in the kill book was generally not entered in the weight book. The number of entries for other than custom animals in the kill book did not, however, always correspond with the number of entries in the weight book. For example, the number of entries in each of those books for the period July through December of 1971 is summarized below:

	Total No. of Entries		
Month	Kill Book*	Weight Book	Difference
7/71	315	303	12
8/71	294	300	(6)
9/71	245	245	0
10/71	288	286	2
11/71	250	228	22
12/71	304	223	81

Total	1,696	1,585	111

*Entries other than "custom."

Petitioner essentially used the weight book as an accounts payable ledger. Each week he would add the total weight from each supplier and issue a check based on that weight. The weight book did not note the price per pound or the total amount to be paid to a supplier.

Petitioner kept track of sales and accounts receivable for boned meat through the use of sales invoices. These invoices were not sequentially numbered, however, and it is not possible to determine from them the total sales of boned meat for any year at issue. The only invoices produced at trial were for a 6-month period in 1971, and petitioner claimed he could not find any for the other 6 months of that year or for 1970

or 1972. Petitioner did not establish or maintain an accounts receivable ledger for the sale of the by-products.

Petitioner regularly deposited the checks from the sales of boned meat on behalf of S & S, but sometimes he withdrew cash proceeds from those checks at the time of the deposit. The checks from the sales of the by-products were not deposited. Petitioner cashed these checks and usually did so on days other than the days when he made the regular deposits. He cashed 60, 99, and 54 of such checks in 1970, 1971, and 1972, respectively. The cash received by petitioner from the above transactions may be summarized as follows:

Source of Check	Year Cash Received 1970	1971	1972
Sales of Boned Meat	$ 6,191.75	$ 2,098.75	$ ---
Sales of By-Products	14,233.94	41,153.45	21,483.96
Total[2]	$20,415.69	$43,252.20	$21,483.96

Tax Return Preparation and Investigation

Petitioners' tax returns for 1970 through 1973 were prepared by Gordon Schroeder, a certified public accountant. Mr. Schroeder was not informed by petitioner that any cash purchases of animals had been made during those years.

On September 21, 1973, petitioner was stopped by the Madison, Wisconsin police. The police searched petitioner's automobile and found a small quantity of marijuana and approximately $21,000 in currency. Shortly thereafter, the

Internal Revenue Service was notified of these facts and Charles H. Reppert, who at that time was a revenue agent, was assigned to examine petitioner's 1972 tax return. Mr. Reppert first met with petitioner in October or November of 1973, and they had several meetings during the course of Mr. Reppert's examination. Petitioner told Mr. Reppert that all of S & S's gross receipts were deposited in a bank account and that the amount of sales reported on his tax returns was based on the amount of deposits in that account, with some adjustment for year-end accruals. Although petitioner met with Mr. Reppert on several occasions prior to

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[2]Respondent determined that, of the total cash received, petitioner failed to report $20,315.69, $42,652.20, and $21,483.96 in 1970, 1971, and 1972, respectively.

December of 1975, it was not until December, when petitioner was accompanied by counsel, that he first claimed that he purchased some animals in 1970 through 1972 for cash.

Limitations

Section 6501(a) generally provides that an income tax must be assessed within 3 years after the filing of a return or the due date for the return, whichever is later. In the instant case, the statutory notice of deficiency in docket No. 8215-78 was issued April 13, 1978, more than 3 years after petitioners filed their 1970, 1971 and 1972 returns. Accordingly, respondent has the burden of proving an exception to the general period of limitations. Farmers Feed Co. v. Commissioner, 10 B.T.A. 1069 (1928). Respondent raises the exception to the

general period of limitations set forth in section 6501(c)(1), i.e., in the case of a fraudulent return[3] Respondent's burden under this exception is the same as that which respondent bears in sustaining an addition to tax for fraud under section 6653(b). Asphalt Industries, Inc. v. Commissioner, 384 F.2d 229, 232 (3rd Cir. 1967); Botwinik Brothers of Mass., Inc. v. Commissioner, 39 T.C. 988, 996 (1963). To satisfy his burden in this case, respondent must show by clear and convincing evidence that (1) there is some underpayment in peti-

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[3]SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

* * *

(c) Exceptions. --

(1) False return. -- In the case of false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time.

tioners' tax for each of the years 1970 through 1972 and (2) that a part of that deficiency is due to fraud. Section 7454(a); Rule 142(b); Levinson v. United States, 496 F.2d 651 (3d Cir. 1974); Miller v. Commissioner, 51 T.C. 915, 918 (1969). It is only after this burden has been met that respondent may rely on the presumptive correctness of his notice of deficiency for determinations with respect to which evidence is lacking. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).[4]

For reasons subsequently set forth, we conclude that respondent has carried his burden of proving that petitioners' 1970, 1971, and 1972 returns were fraudu-

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[4]See Breen v. Commissioner, T.C. Memo 1983-645; Compton v. Commissioner, T.C. Memo 1983-642; and Hansen v. Commissioner, T.C. Memo. 1981-98.

lent within the meaning of sections 6501(c)(1) and 6653(b). The statutory notice was therefore timely issued for each of those years.

Understatement of Taxable Income

Respondent contends that in each of the years 1970, 1971, and 1972, petitioner understated the gross receipts of S & S Meats and thereby understated his taxable income. Petitioner does not deny that he reported the gross receipts of S & S based on total deposits, and he concedes that he cashed the subject checks. He asserts, however, a three-pronged argument as to why his taxable income was not understated.

Petitioner first argues that respondent has not met his burden of showing by clear and convincing evidence that the cash received from the checks

was not subsequently deposited and thus included in gross receipts. He has not suggested any reason why he (or anyone) would regularly cash checks and then turn around and deposit the cash. Petitioner does not claim that he pursued such an illogical course of action. To the contrary, he affirmatively asserts (see infra) that he used the proceeds received by him to purchase animals for S & S. In any event, Mr. Reppert testified that he examined some of petitioner's deposit slips for each of the years in issue and found no record of cash deposited and that he interviewed the bank's bookkeeper, who informed him that petitioner had made no cash deposits during the period she worked for the bank and prior to 1974. No objection was made to this testimony. We are convinced that peti-

tioner did not deposit the cash received from the checks.

Petitioner stated to Mr. Reppert that the gross receipts reported on his tax return were based on actual deposits. He has not subsequently denied that he made that statement nor that it was correct. His deposits included neither cash drawn from checks cleared through the bank as deposits nor checks for the sale of by-products, which he cashed in a manner that prevented tracing from deposit slips. This evidence is clear and convincing that gross receipts were substantially understated.

Petitioner next argues that, even if his gross receipts were understated, respondent has not shown the tax years to which such understatements applied. S & S maintained its books on an accrual

basis and, according to petitioner, it is possible that the checks cashed represented sales made in prior years. The facts do not support his argument.

Most of the checks cashed by petitioner were from the sale of by-products. The fact that petitioner did not establish an accounts receivable ledger for these sales suggests that the typical length of time between such sale and the date a purchaser issued a check in payment was minimal. Petitioner cashed 60, 99, and 54 checks from the sale of by-products in 1970, 1971, and 1972, respectively. Petitioner's claim that all of those checks may represent sales from a year other than the year in which they were cashed is unworthy of belief. Checks cashed in 1971 or 1972 would at most be attributable to sales in the

prior year, which is also before the Court. "In sustaining his burden of proof, respondent is not required to prove the precise amount of the underpayment resulting from fraud, but only that 'any part' of the underpayment is attributable thereto." Otsuki v. Commissioner, 53 T.C. 96, 105 (1969). It is unfortunate that neither party provided the Court with the dates of the checks involved.[5] On the basis of the instant record, however, we conclude that at least a major portion of the checks represents sales made in the year that they were cashed.

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[5]The gaps in the evidence appear unjustified and place an unnecessary burden on the Court. We are satisfied, however, that the totality of the evidence clearly and convincingly establishes each element necessary to respondent's case and the results reached herein.

Petitioner finally argues that any understatement of gross receipts of S & S for 1970, 1971, and 1972 did not cause an understatement of petitioners' taxable income because deductions for cash purchases of animals were not claimed for those years, and such additional deductions more than offset any increase in gross receipts. Because respondent presented clear and convincing evidence of unreported gross receipts, petitioner had the burden of proving his contention that his unclaimed deductible expenses offset those receipts. United States v. Shavin, 320 F.2d 308 (7th Cir. 1963).[6]

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[6]"It is uniformly the rule, even in criminal tax evasion cases where the Government bears the greater burden of proof beyond a reasonable doubt, 'that evidence of unexplained receipts shifts to the taxpayer the burden of coming forward with evidence as to the amount of offsetting expenses, if any.' Siravo v. United States, 377 F.2d 469, 473 (1st Cir. 1967)." Bourque v. Commissioner, T.C. Memo. 1980-286, 40 T.C.M. 824, 833.

Petitioner did not maintain records as to the number or amount of cash purchases and offered only his own estimates and the opinion testimony of Paul Yeager, which, for the reasons stated below, must be discounted. Although we are convinced that petitioner made some cash purchases, we do not believe that such purchases approximated the total amount of unreported receipts.

Mr. Yeager, a certified public accountant, examined the sales invoices, check stubs, and kill and weight books of S & S for the 6-month period July through December, 1971. He did not examine those materials for the remaining periods in issue because the 1970 weight book and the sales invoices and check stubs for those periods were not provided to him by petitioner. Mr. Yeager compared the

total boned meat sold per the sales invoices with the total weight of the carcasses in the weight book and determined that S & S realized an unreasonably high yield of boned meat. He then assumed that the only explanation for this high yield was that animals must have been purchased for cash and that their carcass weight was not entered in the weight book. Based on this assumption and assuming an average carcass weight of 506 pounds per animal and cost of 20 cents per pound, he estimated that petitioner made the following cash purchases:

Year	Number of Animals	Total Cost
1970	210	$21,262.50
1971	520	52,650.00
1972	371	37,563.75

Mr. Yeager's estimates must be viewed, however, in the light of several

inherent weaknesses. First, his estimates were based on the assumption that the only possible explanation of a high yield of boned meat from carcass weight was unrecorded cash purchases of animals. Petitioner testified that he purchased small amounts of finished meats for resale and that he sometimes sold beef by the entire carcass. Mr. Yeager does not appear to have accounted for these facts in his calculations. Second, Mr. Yeager's calculations were made from only 6 months of S & S's records, and they rely heavily on the accuracy of those records. These records, however, were totally inadequate. The sales invoices were not consecutively numbered, and it is impossible to determine accurately total sales therefrom; it is not possible to determine whether an

entry labeled "custom" in the kill book referred to an animal owned by a farmer or purchased by S & S; and for the 6-month period examined by Mr. Yeager, the kill and weight books reflected a substantially different number of entries.

Third, Mr. Yeager's estimates were inconsistent with petitioner's own testimony. When questioned as to the number of animals purchased for cash, petitioner stated: "It would vary. Some weeks it would be 10 to 15 purchased, and maybe for a two or three week period there may be none." Petitioner's testimony, at best, supports only a conclusion that he purchased 270 animals per year (i.e., 15 animals purchased every third week), a number substantially less than the 520 and 371 animals estimated by Mr. Yeager for 1971 and 1972, respectively. In any

event, this Court is not bound by the testimony of an expert witness; it must be rejected where the witness overlooked significant factors in reaching his conclusion. See South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 898 (5th Cir. 1966), affg. 43 T.C. 540 (1965).

Respondent, on the other hand, argues that petitioner made no cash purchases of animals during the period 1970 through 1973. We are convinced for several reasons, however, that petitioner made some cash purchases of animals. It is not unusual for cash purchases to occur as described by petitioner, and his testmony that discounts were available for cash is not incredible. Harold Starks, a former employee of petitioner, testified that he saw petitioner make some cash purchases of animals from

farmers. A few of the entries labeled "custom" in the kill book are also labeled "conditional." If all the "custom" animals actually belonged to farmers as respondent claims, there would be no reason to mark a transaction as "conditional." Accordingly, we conclude that petitioner did purchase some animals for cash, but not to the extent of unreported receipts established for each year, i.e., $20,315.69 for 1970, $12,652.20 for 1971, and $21,483.96 for 1972. Having concluded, however, that there were some cash purchases, we must make as close an approximation of the amount as we can, bearing heavily upon the taxpayer whose inexactitude is of his own making. Cohan v. Commissioner, 39 F.2d 540, 544 (2d Cir. 1930). Based on the entire record before us, we conclude

that in each of the years 1970 and 1971, S & S purchased 175 animals at a total cost of $10,000 and that during the portion of the year the business was operated as a sole proprietorship in 1972, S & S purchased 115 animals at a total cost of $6,500.

Inasmuch as these deductions are substantially less than the unreported receipts, a deficiency exists for each of the years 1970, 1971, and 1972.

Additions to Tax

The existence of fraud is a question of fact to be resolved upon consideration of the entire record. Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978). Fraud will never be presumed. Beaver v. Commissioner, 55 T.C. 85, 92 (1970). The evidence must

show that the taxpayer intended to conceal, mislead, or otherwise prevent the collection of such taxes. Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d cir. 1968); Webb v. Commissioner, 394 F.2d 366 (5th Cir. 1968), affg. a Memorandum Opinion of this Court. Fraud may, however, be proved by circumstantial evidence because direct proof of the taxpayer's intent is rarely available. The taxpayer's entire course of conduct may establish the requisite fraudulent intent. Stone v. Commissioner, 56 T.C. 213, 223-224 (1971); Otsuki v. Commissioner, supra at 105-106.

Having concluded that taxable income was understated, we are compelled by several facts to infer that such understatement was due to fraud. In particular, petitioner stated to former Revenue

Agent Reppert that all of the gross receipts of S & S were deposited when, in fact, petitioner personally cashed numerous checks totaling $20,415.69, $43,252.20, and $21,483.96 in 1970, 1971, and 1972, respectively. He also initially failed to disclose his dealings in cash later claimed to be used for purchases. Such conduct is a strong indication of the intent to mislead or conceal that is a predicate to the imposition of the additions to tax for fraud. Petitioner's pattern of (1) cashing checks from the sale of by-products (for which he maintained no accounts receivable), (2) cashing these checks on days other than the days when he made regular deposits, and (3) usually not cashing the checks from regular customers (for which he did maintain accounts receivable), may

also be viewed as an attempt to mislead or conceal. A further indication of fraud is petitioner's pattern of consistent failure to disclose income from the sale of by-products and to report the tax due on that income on his 1970 through 1972 returns. See Powell v. Granquist, 252 F.2d 56, 60 (9th Cir. 1958).

A person with petitioner's general intelligence and business experience must have been aware of the recordkeeping requirements of the revenue laws. See Otsuki v. Commissioner, supra at 112. Petitioner did not, however, maintain adequate books and records. He has failed to explain the disappearance of records. He testified that he attempted to keep his cash separate from that of S & S simply by knowing in his own mind how much belonged to whom, and he asks us

to rely on his representations in that regard.

Petitioner's statements to Mr. Reppert and his testimony at trial contained many inconsistencies and incredible assertions. He failed to deny or explain incriminating evidence under circumstances in which silence may be deemed an admission. See Ishler v. Cook, 299 F.2d 507, 510 (7th Cir. 1962). In 1975 or 1976, he was convicted of an unrelated felony. See Fed. Rules of Evidence, Rule 609. We therefore disregard his testimony to the extent that it is controverted by stronger evidence.

Upon the basis of the foregoing and consideration of the record as a whole, we hold that respondent has proved by clear and convincing evidence that a part

of the deficiency in each of the taxable years 1970 through 1972 was due to fraud on the part of petitioner.

Advertising

Sometime in 1972 petitioner paid $1,000 to Gene Wegner to sponsor a race car. Petitioner deducted this expenditure as "advertising" on Schedule C, Form 1040 for 1972.

Section 162 generally provides that a deduction shall be allowed for ordinary and necessary expenses incurred in carrying on a trade or business. "Ordinary" has been interpreted as that which is "normal, usual or customary" in the taxpayer's trade or business. Deputy v. DuPont, 308 U.S. 488, 495 (1940). "Necessary" has been construed to mean "appropriate" or "helpful," not "indispensable" or "required." Ford v. Commis-

sioner, 56 T.C. 1300, 1306 (1971), affd. 487 F.2d 1025 (9th Cir. 1973). An activity for which advertising expenses are claimed must be reasonably calculated to advertise the business of the taxpayer.[7]

Respondent's only contention seems to be that petitioner has not shown a proximate relationship between the race car sponsorship and the business of S & S. Respondent does not contend that the expenditure was not made or was unreasonable in amount.

The race car was raced at several local circuits. The sponsorship of the car entitled petitioner to have the name "S & S Meats" displayed on the vehicle and track announcers periodically referred to the car by the name of the

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[7]See Lang Chevrolet Co. v. Commissioner, T.C. Memo. 1967-212.

sponsor. These races were frequently attended by local farmers, and S & S Meats sometimes purchased distressed animals directly from these farmers. Under these circumstances, we conclude that petitioner has shown that the sponsorship expenditure was reasonably calculated to advertise the business of S & S. Such expenditure is therefore deductible under section 162.

Remodeling Expenditures

In April of 1972, petitioner terminated his business relationship with Mr. Dobrzynski, who had previously handled the retail operations. Shortly thereafter, petitioner engaged Hercules Construction (Hercules) to perform various work at the slaughterhouse. The retail portion of the plant, including a smoke house, dairy cooler, and retail cases,

was removed and the facilities were remodeled into a more complete boning operation. Payments were made to Hercules in 1972 by both petitioner and S & S Meats, Inc. Petitioner deducted his payments to Hercules as repairs on Schedule C, Form 1040 for 1972.

In his notice of deficiency, respondent determined that payments made by petitioner to Hercules in 1972 totaling $4,617.89 for work performed at the slaughterhouse were capital expenditures and thus not currently deductible. Respondent also determined that a payment of $500 by petitioner to his father was not deductible. Petitioner, on the other hand, contends that the amounts paid to Hercules were for work in the nature of repairs and are therefore currently deductible. Respondent now concedes that

if the expenditures were capital in nature, petitioner is entitled to a depreciation deduction for 1972 under section 167.

In Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962), this Court stated that the proper test for distinguishing between a repair and a capital expenditure is "whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure." See also Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103, 106 (1926). In this case, petitioner's own description of the work performed on the slaughterhouse shows that it was to remove the retail facilities and replace them with facilities

used in the boning process, rather than to merely repair or mend existing facilities. Accordingly, we hold that these expenditures must be capitalized.

Petitioner offered no evidence regarding the payment of $500 to his father. Respondent's determination as to the nondeductibility of this payment is therefore sustained. Welch v. Helvering, supra; Rule 142(a).

Constructive Dividends

A. Cash Held by Petitioner

S & S, Inc., was incorporated September 1, 1972, and adopted a January 31 fiscal year-end. The corporate tax returns for the taxable years ending January 31, 1973, and January 31, 1974, were prepared by Mr. Schroeder. At the end of each of those periods an adjusting journal entry was made by Mr. Schroeder

to S & S, Inc.'s books to reflect cash on hand but not deposited in a corporate account, as follows:

Tax Year Ending	Account	Journal Entry Debit	Journal Entry Credit
1/31/73	Cash	$18,604.06	
	Sales		$18,604.06
1/31/74	Cash	$19,595.94	
	Sales		$19,595.94
Total		$38,200.00	$38,200.00

On April 15, 1974, petitioner deposited $30,000 in currency in the account of S & S, Inc. Prior to that date, no notes or other evidence of an obligation existed indicating a loan by S & S, Inc., to petitioner.

Respondent argues that petitioner had uncontrolled personal use of corporate funds and that such use constitutes a constructive dividend under sections 301 and 316. Petitioner contends that the adjusting journal entries were a mistake

caused by miscommunication between him and S & S, Inc.'s accountant. He argues for the first time on brief that "the accounting entries are obviously in error because there were no cash sales by the corporation and the Petitioner was not cashing any corporate checks." Petitioner asserts that all of the cash in his possession was his own from salary, rental income, and the collection of accounts receivable retained by him at the time S & S was incorporated. This argument is unpersuasive. Petitioner did not offer the testimony of the accountant, and his argument is contradicted by statements in his own petition in docket No. 7933-77. Paragraph 5 of that petition states:

> (5) The facts upon which Petitioners rely, as a basis of

their case, are as follows:

* * *

(k) As President and Chief Operating Officer of S & S Meats, Inc., Petitioner Duane Hestnes often had in his possession cash sales receipts of said corporation.

(l) Cash sales receipts in the possession of Duane Hestnes were accounted for on the books of S & S Meats, Inc. and taxes paid thereon.

(m) Said cash sales receipts were in fact deposited to the credit of S & S Meats, Inc. by Petitioner Duane Hestnes.

Again petitioner is confronted by his own inconsistent statements. We conclude that petitioner has failed to prove

error in respondent's determination that he received constructive dividends of $14,883.25 and $21,683.76 in 1972 and 1973, respectively.[8]

B. Payment by S & S, Inc. to Hercules

In 1972 S & S, Inc. paid $2,434.36 to Hercules. Respondent determined that this payment was in satisfaction of a personal obligation of petitioner and as such constitutes a constructive dividend

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[8]Respondent determined the amount of constructive dividends as follows:

	1972	1973
$18,604.06 [cash] divided by 5 months [short tax year] x 4 months in 1972 =	$14,883.25	
$18,604.06 [cash] divided by 5 months [short tax year] x 1 month in 1973 =		$ 3,720.81
$19,595.94 [cash] divided by 12 months x 11 months in 1973 =		$17,962.95
Total	$14,883.25	$21,683.76

under sections 301 and 316. Petitioner argues that under the terms of the lease between S & S, Inc. and himself, the corporation was required to pay all building expenses. This argument does not, however, address the heart of the issue, i.e., who was obligated to Hercules and for what? If the obligation to Hercules was a personal obligation of petitioner, then the satisfaction thereof by the corporation is dividend income to petitioner. Sections 301 and 316. If, on the other hand, the obligation was that of the corporation, then the satisfaction thereof is not income to petitioner. Petitioners bear the burden of persuasion and the ultimate burden of going forward with the evidence on this issue. Welch v. Helvering, supra; Rule 142(a).

Shortly after terminating his business relationship with Mr. Dobrzynski in April of 1972, petitioner contracted with Hercules to perform some construction work at the slaughterhouse. S & S, Inc. was not incorporated until September 1, 1972. Petitioners have not established whether the payment by S & S, Inc. to Hercules was in satisfaction of the pre-existing contract obligation of petitioner or was in satisfaction of an obligation of S & S, Inc. Accordingly, respondent's determination as to this issue must be sustained.

Decisions will be entered under Rule 155.

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604
April 11, 1985

Before
Hon. WALTER J. CUMMINGS, Chief Judge
Hon. RICHARD D. CUDAHY, Circuit Judge
Hon. WILBUR F. PELL, JR., Senior Circuit Judge

No. 84-1782

DUANE O. HESTNES and JEAN HESTNES,)
)
Petitioners-Appellants,)
)
vs.)
)
COMMISSIONER OF INTERNAL REVENUE,)
)
Respondent-Appellee.)

Appeal from the United States Tax Court

This cause was heard on the record from the United States Tax Court, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the United States Tax Court in this cause appealed from be, and

the same is hereby, AFFIRMED, with costs, in accordance with the order of this Court entered this date.

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Chicago, Illinois 60604
Argued January 11, 1985
April 11, 1985

Before
Hon. WALTER J. CUMMINGS, Chief Judge
Hon. RICHARD D. CUDAHY, Circuit Judge
Hon. WILBUR F. PELL, JR., Senior Circuit Judge

No. 84-1782

DUANE O. HESTNES and JEAN HESTNES,)
)
Petitioners-Appellants,)
)
vs.)
)
COMMISSIONER OF INTERNAL REVENUE,)
)
Respondent-Appellee.)

Appeal from the United States Tax Court

ORDER

This is an appeal from a decision of the United States Tax Court sustaining the commissioner's determinations of deficiencies in the taxpayers' 1970, 1971, 1972 and 1973 federal income taxes

and of additions to the tax due from taxpayer Duane O. Hestnes for the years 1970, 1971 and 1972. Petitioner taxpayers challenge 1) the tax court's determinations that understatements of income were due to fraud, 2) the court's method of calculating the tax deficiency and 3) its conclusion that taxpayer Duane O. Hestnes failed to shift the burden of proof to the Commissioner regarding the existence of constructive dividends. For the reasons set forth below, we affirm.

I

The facts below are based on stipulations by the parties and on the tax court's findings. Taxpayer Duane O. Hestnes, during the tax years in question, operated a business involving the purchase, slaughter and processing of cattle, under the name "S & S Meats."

Duane's wife Jean Hestnes did not participate in the business. The Hestnes' filed timely joint federal income tax returns for 1970 through 1973. During the initial portion of the years in question the business was operated as a sole proprietorship. Taxpayer Duane Hestnes incorporated the business in September of 1972 as "S & S, Inc.", became the corporation's president and sole shareholder and continued to operate the business largely in the same manner as he had prior to incorporation. The operation specialized in the slaughtering of "distressed" cattle (animals that are not healthy, e.g., suffering from foot rot or broken legs) and the sale to wholesalers of the boned meat.[1]

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[1]The taxpayers were specially licensed to slaughter such animals, which were routinely examined by state inspectors after slaughter.

S & S purchased meat from three primary sources. The main source was independent suppliers who purchased distressed animals from farmers and sold those animals to S & S. A supplier received payment from the S & S business by check, but only if the delivered animal passed inspection. The second source of animals came from purchases by Hestnes of generally nondistressed cattle at public sales. Payment for these animals was also by check but was final regardless of whether the cattle ultimately passed inspection. The final source of animals derived from the business' purchases of animals directly from farmers. The volume of these purchases was erratic and payment was made both in cash and by check.

Although S & S derived the majority

of its gross receipts from the sale of boned meat, the sale of animal by-products also provided some revenue. In addition, a small amount of revenue was derived from the "custom slaughter" of cattle owned by farmers which involved the return of butchered meat to the farmer.

The taxpayer's record-keeping for S & S was "at best minimal." No records at all were maintained regarding the number of animals purchased with cash or the amount paid for those animals. Cattle brought to S & S for slaughter were accounted for in a "kill book." Entries in that book normally included the number and type of animals brought in on that date, an indication of the terms of payment and the name of the supplier. After the carcass of an animal passed

inspection, it was weighed. That weight and the name of the supplier were entered in a "weight book" for the date on which the animal was slaughtered. Unexplained discrepancies existed between the number of entries in the weight and kill books. (App. 7.)

Taxpayer utilized the weight book as an accounts payable ledger. Each week he would add the total weight from each supplier and issue a check based on that weight. The weight book did not note the price per pound or the total amount to be paid to a supplier. Hestnes kept track of sales and accounts receivable for boned meat through the use of sales invoices. These invoices were not sequentially numbered, however, and it is not possible to determine from them the total sales of boned meat for any given

year at issue. Defendant taxpayer produced invoices for a six-month period in 1971 at trial, but claimed that he could not find any for the other six months of that year or for 1970 or 1972. No accounts receivable ledger was maintained for the sale of by-products.

The taxpayer regularly deposited checks from the sale of boned meat on behalf of S & S, but sometimes withdrew cash proceeds from those checks at the time of deposit. The checks from the sale of by-products, however, were not deposited. The taxpayer cashed these checks, and normally did so on days other than when he made regular deposits. Hestnes cashed 60, 99 and 54 of these checks in 1970, 1971 and 1972, respectively. The cash received from the above transactions amounted to $20,416 in 1970,

$43,522 in 1971 and $21,484 in 1972. During the period followiing incorporation in 1972 and in 1973, the taxpayer took into possession cash sales receipts of the corporation amounting to $14,883 in 1972 and $21,684 in 1973.

A tax investigation of taxpayer was initiated after a large quantity of cash, $21,000, was found in his possession by local police during a stop of his automobile. Revenue agent Charles H. Reppert was assigned to examine the taxpayer's tax returns. Taxpayer originally represented to the agent in November of 1973 that all of the gross receipts of S & S were deposited in a bank account and that the amount of sales reported on his tax returns was based on the amount of deposits in that account. In December of 1975, after several meetings with the

agent, taxpayer revealed for the first time that he had purchased some animals for cash during the years 1970 through 1972.

The Commissioner determined that a deficiency existed in the taxpayer's tax liability for each of the years 1970 through 1973. The deficiencies for the first three years resulted chiefly from the Commissioner's determination that virtually all of the amounts of the checks cashed by taxpayer represented unreported income. The Commissioner also determined that the cash amounts taken into taxpayer's possession from the business during the time period in which the business was incorporated constituted constructive dividends and gross income to the taxpayer. See 26 U.S.C. §§ 301, 316. Finally, the Commissioner deter-

mined that Hestnes was liable for additions to the tax because of fraud committed by the taxpayer during the years 1970 through 1972. See 26 U.S.C. § 6653(b).

The tax court upheld the Commissioner's determinations, with some minor adjustments, in a proceeding brought by the taxpayer for redetermination of the deficiencies asserted. Hestnes does not appeal the tax court's determinations that deductions taken by Hestnes for certain expenditures incurred in 1972 were unavailable to him. The court ruled that the statute of limitations was not a bar to the Commissioner's asserted deficiencies because the government met its burden under 26 U.S.C. § 6501(c)(1), which creates an exception to the normal three-year limitations period, see 26

U.S.C. § 6501(a), in the case of a fraudulent return. See Gromacki v. Commissioner, 361 F.2d 727, 731 (7th Cir. 1966).

II

A. Additions to Tax Attributable to Fraud

The taxpayer asserts that the Commissioner failed to meet his burden of proving that any under-reporting of income on Hestnes' part was "due to fraud and with intent to evade tax." Lydon v. Commissioner, 351 F.2d 539, 545 (7th Cir. 1965).[2] The tax court inferred from several facts that the taxpayer's understatements of income were due to fraud. The court primarily relied on the follow-

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[2]Petitioner has not denied below nor on appeal that he failed to report gross receipts in the tax years in question, but rather challenges the tax court's method of computing any net deficiency in income. See infra p. [A44].

ing conduct of Hestnes: 1) false statements to revenue agent Reppert that all gross receipts of S & S were deposited in the business' bank account when in fact taxpayer cashed numerous checks of the business worth approximately $85,000 over a three-year period and the failure to disclose to the agent certain cash dealings, 2) a pattern of cashing checks from the sale of by-products (for which no accounts receivable were maintained) on days other than when Hestnes made regular deposits, and of not cashing checks received from regular customers (for which accounts receivable were maintained), and 3) a pattern of consistent failure to disclose and report income from the sale of by-products during 1970 through 1972. The court additionally noted that the failure of taxpayer to

maintain adequate books and records in accord with requirements of the tax laws and his failure to explain the disappearance of other records contributed to its finding of fraud. Finally, the court explained that it disregarded much of Hestnes' testimony at trial that tended to refute the inference of fraud because the defendant lacked credibility. The conclusion as to Hestnes' credibility as a witness was based on his "many inconsistencies and incredible assertions" made at trial, his failure to explain certain other incriminating evidence, and his prior conviction for an unrelated felony.[3] (App. 20-21.)

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[3]The taxpayer's argument that the court erred in considering his prior felony conviction (cocaine distribution) in judging the credibility of his testimony is specious. Evidence of a prior felony (footnote continued on following page)

We first set forth the standard governing civil tax fraud cases. The determination that a failure to report income amounts to fraud is a question of fact to be resolved upon consideration of all the evidence. Plunkett v. Commis-

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(footnote continued from previous page)
[3]conviction is admissible under Fed. R. Evid. 609(a)(1) for impeachment purposes if the court determines that the probative value of the evidence outweighs its prejudicial effect to the defendant. The determination of whether the probative value outweighs the prejudicial effect rests within the sound discretion of the trial court. 10 Moore's Federal Practice § 609.14[3) (1984). Hestnes does not explain in what manner the tax court abused its discretion, but merely notes that no explicit balancing of prejudice and probative value consistent with our urgings in United States v. Mahone, 537 F.2d 922, 929 (1976), certiorari denied, 429 U.S. 1025, appears in the record. Mahone only encouraged lower courts to set forth an explicit finding on the probative/prejudice issue, and did not rule that a failure to do so of itself would constitute an abuse of discretion. Furthermore, we find no abuse of discretion on these facts, particularly where the court was the trier of fact.

sioner, 465 F.2d 299, 303 (7th Cir. 1972). Although the government is required to establish fraudulent conduct by clear and convincing evidence, the court's finding of fraud will not be disturbed unless it is clearly erroneous. Commissioner v. Duberstein, 363 U.S. 278, 291; Candela v. United States, 635 F.2d 1272, 1274 (7th Cir. 1980). The evidence must show that the taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead or otherwise prevent the collection of taxes. See Stolzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968), certiorari denied, 393 U.S. 1020; Webb v. Commissioner, 394 F.2d 366 (5th Cir. 1968). It is clear, however, that fraud may be proven by circumstantial evidence (since direct proof of the taxpayer's intent is rarely

available) and that the taxpayer's background and entire course of conduct may be considered in the determination. See Plunkett, 465 F.2d at 303; Stone v. Commissioner, 56 T.C. 213, 223-224 (1971); Otsuki v. Commissioner, 53 T.C. 96, 105 (1969).

Hestnes argues that the tax court failed to consider its own finding of taxpayer's unclaimed business deductions in its determination of fraud and that the court erroneously concluded that the evidence submitted by the government met the clear and convincing standard. Taxpayer's assertions are without merit.

The tax court's finding of fraud can in no way be characterized as clearly erroneous. Hestnes attacks the government's case by singling out four pieces of evidence relied upon by the tax court

in reaching its finding of fraud (pattern of cashing checks, pattern of understating income, failure to keep records and false and inconsistent statements made during investigation, see supra p. [A44]), and argues that each item individually would not support a finding of fraud. See, e.g., Anthony Canzano, 46 T.C.M. 368, 376 (1983) (failure to keep records sometimes only may indicate negligence and not fraud); John C. Barrier, 46 T.C.M. 100, 109 (1983) (subsequent conduct, such as later statements, only is relevant to proving fraud if fraudulent intent is shown to have existed when return was made); Loftin & Woodard, Inc. v. United States, 577 F.2d 1206, 1239 (5th Cir. 1978) (the mere understatement of income, standing alone, is not sufficient to support a finding of fraud).

This apprpoach, of course, ignores the rule that a court is obliged to consider all the evidence presented and consider the taxpayer's entire course of conduct in determining the presence of fraud.

Each of the indicia listed by the tax court has been held probative on the issue of tax fraud. See Spies v. United States, 317 U.S. 492, 500 (inadequate and misleading records); United States v. Pistante, 453 F.2d 412 (9th Cir. 1971) (subsequent false and inconsistent exculpatory statements); Candela, 635 F.2d at 1274 (consistent and substantial pattern of understating income); Stone, 56 T.C. at 224 (pattern of conduct to conceal income or to avoid making records usual in a transaction of the kind); see also American Lithofold Corp. v. Commissioner, 55 T.C. 904, 924, 925 (1971). This Court

recognizes that a consistent pattern of understatement of income alone is "persuasive evidence of fraud." Candela, 635 F.2d at 1274. See Estate of Upshaw v. Commissioner, 416 F.2d 737 (7th Cir. 1969), certiorari denied, 397 U.S. 962; Sherwin v. United States, 320 F.2d 137, 141 (9th Cir. 1963), certiorari denied, 375 U.S. 964. Moreover, a finding of such a pattern of understatement of income, combined with other evidence of fraud, has been held to support a determination of fraud on facts less compelling than those before us. See Estate of Upshaw, supra (substantial and consistent undertatement of income, failure to maintain adequate books, and material misstatement to revenue agent); Lydon v. Commissioner, 351 F.2d 539, 545-546 (7th Cir. 1965) (consistent and substantial

understatement of income and income received through a scheme of kickbacks); Merritt v. Commissioner, 301 F.2d 484, 487 (5th Cir. 1962) (substantial and consistent understatement of income, incomplete and inaccurate records, and failure to supply bookkeeper with necessary data to maintain complete records).

Defendant's reliance on Candela is misplaced. In Candela this Court overturned the district court's finding of fraud. The case, however, involved the unique circumstances of a taxpayer who was an unsophisticated and illiterate immigrant. The Court concluded that the omissions in reporting and recording by the defendant resulted from his lack of sophistication rather than from his intent to defraud. 635 F.2d at 1276. The taxpayer here alleges no similar

degree of naivete or lack of sophistication.[4]

Finally, we consider Hestnes' assertion that the tax court improperly disregarded certain unclaimed business deductions of the taxpayer in its weighing of the evidence of fraud. The court specifically ruled that Hestnes had not taken deductions to which he was entitled for cash purchases of cattle in the years 1970 through 1972. This Court has recognized that the existence of unclaimed business deductions is "not without significance" in demonstrating a lack of fraudulent intent with regard to unre-

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[4]The admission of certain hearsay statements regarding the taxpayer's pattern of cashing checks, to which the defendant failed to object below, did not constitute a miscarriage of justice so as to require a remand of this case. See Ellis v. City of Chicago, 667 F.2d 606, 610 (7th Cir. 1981).

ported income. Plunkett, 465 F.2d at 304. It is not clear, however, from the tax court's memorandum opinion that it did not in fact weigh this finding in its fraud determination. Even if the tax court did not consider the probative value of the unclaimed deductions, such a failure would not render the court's finding of fraud clearly erroneous in light of the substantial evidence submitted by the government. In addition, the tax court would be entitled to view the failure to claim certain deductions as part of a larger plan to conceal income.

B. Calculation of Deficiencies

The deficiencies for the years 1970, 1971 and 1972 were based chiefly on the tax court's conclusion that taxpayer had substantially underreported his gross income from the sale of meat and by-

products for those years by cashing rather than depositing certain checks and failing to report those amounts as gross receipts of the business. Taxpayer, as noted above, does not deny that he failed to report these gross receipts, but instead argues that in estimating the amount of taxpayer's unclaimed business deductions, the tax court failed to disclose adequately the basis of its estimates. Hestnes agrees that the court properly invoked the Cohan rule on his behalf, and thereby attempted to approximate the amount of taxpayer's unclaimed business deductions as an offset to unreported income in the tax years at issue, despite the fact that the taxpayer could not substantiate the precise amount of

the deductible expenditures.[5] See Concord Control, Inc. v. Commissioner, 615 F.2d 1153 (6th Cir. 1980); Miller v. United States, 296 F.2d 457, 460 (7th Cir. 1961); Cohan v. Commissioner, 39 F.2d 540, 544 (2d Cir. 1930). The taxpayer correctly notes that in attempting reasonably to approximate an adjustment to the deficiency asserted, the court must reveal the basis or method of calculating the adjustment. Curtis v. Commissioner, 623 F.2d 1047, 1053 (5th Cir.

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[5]The Cohan rule as originally applied in the Cohan case to travel and entertainment expenses has been legislatively overruled. See 26 U.S.C. 274(d). The Cohan principle, however, has enjoyed general application outside the travel and entertainment expense area and apparently survives where not legislatively overruled. See, e.g., Ellis Banking Corp. v. Commissioner, 688 F.2d 1376, 1383 n.12 (11th Cir. 1982). The Commissioner has not challenged its application here.

1980); Miller, 296 F.2d at 460.

Upon reviewing caselaw concerning what constitutes sufficient disclosure of the method or basis of these estimates and in light of the inherently imprecise nature of these estimates, we are convinced that the court more than adequately revealed the basis of its estimate of Hestnes' unclaimed deductions. Relevant authority has not required that a court invoking the Cohan rule reveal a specific formula or mathematical procedure to account for its estimate. Instead, it is sufficient that the record discloses facts constituting the underlying basis of the approximation and that the estimate appears roughly accurate in light of these facts. See Curtis, 623 F.2d at 1053; Miller, 296 F.2d at 460.

Here the tax court devoted five

pages of its memorandum opinion to explaining the manner in which it arrived at its estimate of the taxpayer's unclaimed deductions (App. 15-19). Ultimately, the court concluded that S & S purchased 175 animals at a total cost of $10,000 in each of the years 1970 and 1971 and 115 animals for cash at a cost of $6,500 during the portion of 1972 prior to incorporation. These figures evidently were derived from Hestnes' own testimony with regard to the number of animals purchased for cash: "Some weeks it would be ten to fifteen [cattle] purchased, and maybe for a two or three week period there may be none" (id. at 17). Utilization of an assumption that ten animals were purchased every third week yields almost exactly the court's total of 175 cattle purchased per year.

The court also reduced taxpayer's expert's own estimate of the average carcass weight and cost per pound in determining the total dollar amount of the cash expenditures. The court correctly rejected the expert's estimate of the cash purchases because the estimate was inconsistent with taxpayer's own testimony, was based solely on a six-month span of his inadequate records and assumed facts favorable to petitioner without any basis where ambiguities in the records existed. The tax court did an adequate job in arriving at a fair estimate under the Cohan rule, and the taxpayer here, whose inexactitude created the need for approximation, is in no position to complain.

C. Constructive Dividends

The tax court concluded that the

taxpayer took corporate cash into his personal possession for his unrestricted use during the years 1972 and 1973, and concurred in the Commissioner's determination that the taxpayer received constructive dividends in the amounts of $14,883.25 and $21,683.76 in the years 1972 and 1973 respectively. A dividend under the Internal Revenue Code is "any distribution of property made by a corporation to its shareholders *** out of its earnings and profits ***." 26 U.S.C. § 316(a). There is no requirement that the corporation formally declare the dividend or record it upon the corporate books. See Broadview Lumber Co., Inc. v. United States, 561 F.2d 698, 704 (7th Cir. 1977). A determination of the existence of a constructive dividend, however, must be supported by a finding

that "the corporation has conferred a benefit on the stockholder in order to distribute available earnings and profits without expectation of repayment." Mertens, 1 Laws of Federal Income Taxation § 9.07 (1985). Proof of a distribution of an economic benefit is essential. Id.; Broadview, 561 F.2d at 704. Constructive dividends may be classified in a number of ways including such categories as purported rents, interest, and salaries, interest-free loans and bargain sales. Most relevant to the present situation are cases dealing with the use of corporation property by the stockholders, see, e.g., Ireland v. United States, 621 F.2d 731 (5th Cir. 1980), and with the diversion of corporate funds or receivables to stockholders. See, e.g., Jaeger Motor Car Co. v. Commissioner, 284

F.2d 127 (7th Cir. 1960); Drybrough v. Commissioner, 238 F.2d 735 (6th Cir. 1956), certiorari denied, 365 U.S. 860; Logan Square Auto Mart, Inc. v. Commissioner, 19 T.C.M. 19 (1960), affirmed, 291 F.2d 136 (7th Cir. 1961).

The taxpayer recognizes that the Commissioner's determination of a deficiency (as distinguished from a determination of fraud) is accorded a presumption of correctness in a tax court proceeding and that the taxpayer's burden is to show that the assessment is arbitrary or erroneous. See Hintz v. Commissioner, 712 F.2d 281, 286 (7th Cir. 1983); Tax Court Rule 142(a). The taxpayer does not argue that no economic benefit was derived from the cash admittedly in his possession, but rather claims that no distribution took place because the cash

in his possession did not come from corporate funds or receivables. It is clear, however, that he has failed to meet his burden.

The taxpayer can shift the burden of proof to the Commissioner only by presenting specific evidence sufficient to prove that the assessment was arbitrary or erroneous, Hintz, 712 F.2d at 281, or by presenting "enough evidence to support a contrary finding to the Commissioner's determination." See Valley Title Co. v. Commissioner, 559 F.2d 1139, 1141 (9th Cir. 1977) (quoting Rockwell v Commissioner, 512 F.2d 882, 885 (9th Cir. 1975), certiorari denied, 423 U.S. 1015. Taxpayer here merely offered a plausible alternate source for the large amounts of cash in his possession. Hestnes argued below that the cash in hand came from

some $43,000 in receivables owned by Hestnes that were generated by S & S prior to incorporation. He also claimed that his salary and rent from the corporation were sources of the cash. These assertions alone, however, do not demonstrate, by a preponderance of the evidence, that the cash in taxpayer's possession did not, in fact, come from the corporation.

The taxpayer's theory does not refute the significant evidence relied upon by the tax court of Hestnes' unrestricted use of the corporate funds in question. Accounting entries made by S & S's accountant for 1973 and 1974 reflected substantial amounts of cash on hand but not deposited in a corporate account (App. 25-26). The court chose to reject the taxpayer's unexplained and

unsupported assertion that the entries were mere errors. The taxpayer never refuted the testimony of his accountant which stated that Hestnes often had in his possession cash sale receipts of S & S. The tax court was correct in concluding that Hestnes had not rebutted the presumption of correctness attached to the Commissioner's assessment. The decision of the tax court is affirmed.

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Chicago, Illinois 60604
May 15, 1985

Before
Hon. WALTER J. CUMMINGS, Chief Judge
Hon. RICHARD D. CUDAHY, Circuit Judge
Hon. WILBUR F. PELL, JR., Senior Circuit Judge

No. 84-1782

DUANE O. HESTNES and JEAN HESTNES,

Petitioners-Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court

ORDER

On consideration of the petition for rehearing and suggestion for rehearing en banc filed in the above-entitled cause by appellants Duane and Jean Hestnes, no judge in active service has requested a vote thereon, and all of the judges on

the original panel have voted to deny a rehearing. Accordingly,

IT IS ORDERED that the aforesaid petition for rehearing be, and the same is hereby, DENIED.